SPECIAL REPORT

BOSTON MUNICIPAL RESEARCH BUREAU
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February 9, 1994 No. 94-1

THE IMPACT OF BOSTON CITY HOSPITAL IN SECURING BOSTON'S FINANCIAL HEALTH

Conclusions From A Financial Assessment

- *The extent to which city resources will be required to operate the new Boston City Hospital (BCH) will have a direct impact on the City of Boston's financial health and will play a key role in Boston's future. The Hospital is currently projected to incur operating losses increasing from $2.0 million in 1994 to $7.2 million in 1996. This projection, which represents a "snapshot" of projected revenues and expenditures based on the current operating environment, has created the need for the City to consider a series of options for BCH to provide health care in Boston. However, possible changes in several of the assumptions could significantly increase BCH's operating deficit, thereby limiting options for its future.*

- *Aggressive expenditure control by BCH must continue for it to play a role in this competitive marketplace. The costs for BCH are among the highest in the state, making cost control imperative.*

- *Equally important is that BCH continue to receive special financial consideration from the state and federal governments where it can demonstrate its unique status in serving the poor and indigent.*

- *BCH should re-examine its mission and determine in what areas it can be market distinctive in terms of cost, quality or required services. BCH will need to develop a strategy to attract new patients to sustain its volume. Each 1% drop in patient utilization will result in a revenue loss of approximately $1.1 million.*

- *Changing the Hospital's internal organization and governance structure to eliminate current built-in inefficiencies should be considered. BCH should also establish affiliations with other medical institutions to help meet its redefined mission.*

This Special Report is based on a financial assessment of Boston City Hospital prepared for the Research Bureau by the public accounting firm of Coopers & Lybrand. The Bureau requested this study as part of its comprehensive assessment of the City of Boston's financial position. The main report, Securing Boston's Financial Health, A Blueprint For Boston's Future, was released in September, 1993.

BOSTON CITY HOSPITAL

Boston City Hospital is a component of the Department of Health and Hospitals (DHH), which consists of five units: BCH, Boston Specialty and Rehabilitation Hospital (BSRH-Mattapan), Public Health, Emergency Ambulance Service and Long Island Shelter. BCH is the largest entity of DHH, serving as an acute care trauma center, a teaching hospital of Boston University School of Medicine and a community hospital focusing on the needs of the City's medically underserved and indigent population. The DHH's fiscal 1994 budget is $197.2 million on a statutory budget basis.

On January 29, 1994, in-house patients moved into the new BCH, a single 356-bed facility, which consolidated and modernized medical services. The project was financed through the issuance of $169.3 million of revenue bonds in November, 1990, which were secured by a mortgage on BCH, insured by HUD through the Federal Housing Administration. These bonds were refinanced in June, 1993, and will be paid from the Hospital's operating revenues.

The relative financial contribution by the City of Boston to each of the five units of DHH is helpful in understanding the

significance in the projections of the City's financial requirements for the new BCH over the next few years. The table below shows the operating income for each of the five units over the past four years, with the City's contribution denoted by the numbers in parentheses. Based on fiscal 1993 estimates, this measure of operating performance indicates that two-thirds of the City's contribution is attributable to the Public Health program, followed by support for the Specialty and Rehabilitation Hospital. Of the total city contribution of $31.9 million, BCH accounted for $2.5 million or 8.0%. With the change in the state's system in regulating hospital charges through Chapter 495, BCH has required a relatively modest city contribution in each of the last two years. Nevertheless, given the large city contribution to DHH, a marked increase in that contribution due to larger operating losses of BCH would pose a serious fiscal challenge to the City.

DEPARTMENT OF HEALTH & HOSPITALS ~ OPERATING INCOME BY UNIT
Per Financial Statements - Accrual Basis - $ in Millions

FISCAL YEAR	TOTAL	BCH	AMBULANCE	PUBLIC HEALTH	BSRH	LONG ISLAND
1990	($23,049)	$4,619	($1,015)	($23,076)	($583)	($2,994)
1991	($25,012)	$103	($4,442)	($24,097)	$820	$2,604
1992	($39,029)	($1,657)	($3,255)	($23,784)	($7,132)	($3,201)
1993 EST.	($31,960)	($2,553)	($1,468)	($21,311)	($5,337)	($1,292)
AVERAGE	($29,763)	$128	($2,545)	($23,067)	($3,058)	($1,221)

FINANCIAL ASSESSMENT

The analysis of projected revenues and expenses of BCH through fiscal 1996 shows improvement in the loss from operations from previous projections. Based on the assumptions of BCH's current operating environment and other environmental changes in revenues and expenses, BCH's projected loss from operations has changed from $20.9 million to $7.2 million in fiscal 1996. The revised projection indicates decreases in spending for salaries and wages, supplies and interest costs and other environmental and reimbursement changes. **While progress has been achieved internally by BCH, more is still required if the Hospital is to be financially feasible as an entity in the health care system in the City.**

This financial analysis represents a "snapshot" of projected revenues and expenditures of BCH based on DHH's current assumptions and environmental changes since the last projection. However, as will be explained, possible changes in several of the assumptions could significantly increase BCH's operating deficit, limiting options for its future. Specifically, the projection reflects the following assumptions:

REIMBURSEMENT PAYMENT SYSTEMS

The projected revenues for BCH reflect the continuation of Chapter 495, the state's managed care, competitive pricing legislation, complete with the specific provisions unique to BCH. The Hospital receives a substantial percentage (more than 70%) of its revenues from services provided to Medicaid and Uncompensated Care Pool or free care patients. These payment rates are determined under Chapter 495 and through specific contracts or other agreements with the state. BCH receives certain specific payments in recognition of its unique status of serving the poor and indigent. These payments, which are an important factor in the Hospital's operating performance and which aggregate in excess of $30 million annually, include disproportionate share payments from Medicare, special payment provisions from the Commonwealth, capital cost reimbursement from the Medicaid program and special payment provisions from the Uncompensated Care Pool for bad debts and free care. This special consideration afforded BCH partially insulates the Hospital from the impact of patient volume decline.

As the Commonwealth and other payers are forced to reduce the growth of health care expenditures, these payments may be reduced or curtailed. Reduction of these payments would directly increase the projected deficit for BCH. Thus, continuation of these or similar payment mechanisms and BCH's special status are essential for the financial viability of BCH and for various options being considered for the Hospital.

PATIENT VOLUME

The Hospital's patient volume is assumed to remain unchanged through fiscal 1996 from current levels. BCH's inpatient and outpatient volume in 1993 showed improvement over those experienced in 1992, although these levels fall short of

volume levels forecasted in the Hospital's FHA mortgage application. As noted above, the current reimbursement system partially insulates BCH from the effects of volume decline. However, even a 1% reduction in the projected patient utilization would result in revenue reductions of approximately $1.1 million in fiscal 1996. If BCH were to experience substantial reduction in patient volume, the operating deficit would increase significantly. Several factors could significantly affect patient volume, which will require BCH to focus efforts on attracting new patients.

Substantial changes have already occurred in hospital utilization in the greater metropolitan Boston and Massachusetts areas. These changes include the increase in managed care with reductions in hospitalizations, in average length of stay and the continued funding and access to all hospitals by the indigent through the Uncompensated Care Pool. As health care reform unfolds, many of BCH's traditional patients may become increasingly attractive to the other greater Boston hospitals.

While it is difficult to predict exact volume levels, it is likely that BCH will experience volume reductions over time and that those reductions could be substantial. It is reasonable to expect that reductions in hospital utilization throughout the state will continue in the future since utilization levels in Massachusetts are considerably higher than in other sections of the country. With the continued growth of managed care and competitive pricing, industry experts predict anywhere from 30-50% reduction in patient utilization of hospital inpatient services over the next several years. National health care reform, technological changes, continued expansion of managed care, incentives for treatment outside of hospital settings and other factors can be expected to reduce inpatient hospitalizations. Given the existing overcapacity within Massachusetts and greater Boston, BCH can expect increasing competition for the patients they serve.

As managed care and competition based on pricing increase, BCH will likely experience substantial pressure to reduce charges or suffer declines in patient volume. Currently, payments for services to BCH are generally at rates higher than those paid to other facilities by certain payers. The costs for BCH, adjusted for severity of illness, are among the highest in the state and substantially higher than community hospitals. Cost control, therefore, is imperative as noted below.

OPERATING EXPENSES

The fiscal practices adopted by BCH have reduced current and projected spending and these efforts must continue to be aggressively pursued. Over the past four years, BCH has made substantial progress in reducing the number of its employees. Reducing operating expenses through work force reduction is a key assumption in the ongoing financial viability of BCH. The current update reflects the reduction in the number of hospital employees and more significantly, a reduction from assumed to actual rates of inflation for salaries and wages. This has occurred largely due to continuing changes in the economy and lower general inflation levels. In the four years from 1989 to 1994, the BCH work force decrease is expected to be 412 people or 16.0%. Reduced personnel costs also are due to no salary increases being provided over the last three fiscal years.

Even with current and planned reductions in staff, it is important to note that BCH still operates at approximately 7 full time equivalencies (FTE's) per occupied bed. While it is difficult to assess an appropriate level of FTE's in a municipal hospital serving unique patients such as BCH, this level is still high, particularly in comparison to community-based hospitals. If BCH were required to operate at a level more consistent with community hospitals (or at approximately 5 FTE's per bed), it would mean a 30% additional reduction in the work force at BCH.

CAPITAL COSTS

The current revenues and expenses of BCH reflect certain savings in capital expenditures due to the refunding in 1993 of BCH bonds at lower interest rates and the delay in opening the new facility. The gross savings of the refinancing was $13.3 million with a present value savings of $6.0 million over the term of the bonds. Even with these savings, the capital costs of BCH remain high in comparison to other facilities. BCH's capital costs are approximately 14% of total operating costs in comparison to a national average of approximately 8%. This higher than average capital cost is due to the fact that BCH is essentially a totally new facility. Accordingly, BCH will continue to face the issue of higher than average capital costs spread over a smaller than expected patient base in an increasingly competitive marketplace.

An integral part of the financial requirements of BCH is its ability to maintain its facilities and technology. The Hospital's success in meeting its ongoing capital needs will influence future decisions on quality of care and on service expansion or retention and possibly potential affiliations or alliances. Such capital expenditures are an ongoing requirement of operations. As a point of reference, Boston Teaching Hospitals, individually expend in excess of $10 million annually for ongoing capital needs. The current projections of $2 million for routine capital expenditures at BCH may prove to be inadequate for maintaining the facilities and capabilities of BCH in the competitive marketplace.

RESPONDING TO THE NEW ENVIRONMENT

Conclusions and Recommendations

The current projected statement of revenues and expenditures continues to show an operating deficit for BCH. This projection could worsen depending on changes in the environmental factors previously analyzed. Given the fact that a new Administration is in place, an opportunity exists to re-examine all the various components of the operations and financing of BCH. Some action steps that should be undertaken are:

1) BCH should undertake a re-examination of its mission. Within the context of the mission, it will be important to distinguish and quantify those special services where, in fact, BCH might appropriately receive special treatment with the payers and payment systems. This will be particularly important given the expectations of national health reform. With this articulation, BCH will be in a stronger position to justify its cost structure with the various parties. The by-product of this process will be also to identify what may be a unique role as well as what may justify an appropriate ongoing subsidy by the City of Boston and others for the services provided at BCH.

2) To provide essential information for this assessment of its cost structure, BCH should develop management information systems that will enable it to report both revenues and expenses by program and service category. As part of this effort, it will become increasingly important for BCH to compare its costs with other providers in the areas where there is competitive market demand for its services. BCH's ability to be cost effective in comparable competitive markets is integral to sustain patient volume.

3) The years ahead will require BCH to form linkages that will enhance its ability to "compete" for patients in new ways. An important and distinct linkage for BCH will be the strengthening of its relationships with the neighborhood health centers. The health centers have needs for capital and are concerned with maintaining their own positions in the marketplace. The Boston Teaching Hospitals have already responded in part to these needs. A realistic assessment of how BCH can form attractive partnerships with the health centers must be performed. A successful strategy will require BCH to be patient friendly, physically attractive and establish collaborative physician-to-physician relationships. BCH also will require sufficient capital resources in order to maintain its new facilities and technology.

4) BCH should consider affiliations with other medical institutions. To meet the challenging health care environment, many Massachusetts hospitals have realized the need to form alliances. While BCH's municipal status creates unique concerns, these affiliations would provide the Hospital access to a wider range of services and specialties, managed care contracts and group negotiating advantages, technology and even capital investments and cost efficiencies through consolidations and merging of departments. For BCH, location, common medical staffs and service alignments point logically to an expanded relationship with University Hospital and the Boston University Medical Center.

5) The unique issues of BCH as a municipal hospital with substantial unionization and civil service requirements and complex procurement procedures should be analyzed to identify the legitimate inefficiencies in the current system and to determine alternate solutions. Some of these issues are the result of long standing cultural or attitudinal norms in the Hospital. The long-term solution may well be changes in organizational relationships and governance structure. However, changes in governance alone will not result in the cost and operational improvements needed for BCH.

Looking beyond 1996 raises the question of the impact of health care reform on BCH. Health care reform is already occurring in Massachusetts. Deregulation of the hospital payment systems and the tremendous growth in managed care have already begun to have a major impact. The principles of health care reform focus on universal coverage which, it can be argued, is already provided in Massachusetts through the state's Uncompensated Care Pool and reduction in the cost of health care. As one of the highest cost hospitals in the highest cost state in the country, BCH must lower its cost of health care. BCH must face the challenge of improving its organizational structure and management systems and reconciling its mission to the new environment. With or without health care reform, the continuation of the special payment mechanisms at the state and federal levels is essential to the financial health of Boston City Hospital.